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S Corporations and ESOPs

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Employee Stock Ownership Plans (ESOPs) merge the tax benefits of a qualified retirement plan with corporate finance and align employees' retirement benefits with corporate goals.[1]

While many of the beneficial provisions of sponsoring an ESOP don't apply to S corporations, the tax benefits to an S corporation that adopts an ESOP can be significant. Unlike C corporations, where profits are taxed at the corporate level and taxed a second time when distributed to shareholders, S corporation earnings pass untaxed directly to individual shareholders; therefore, profits aren't taxed until the shareholders file their annual tax returns.

"So what?" you may ask.

So this: imagine a company avoiding (not evading) paying taxes on corporate profits and the beneficial shareholders deferring taxes on the profits to age 70½ or later. An S corporation with an ESOP does exactly that, because the ESOP trust is tax-exempt under IRC Section 501(a). The more shares of the company the ESOP holds, the more income allocated to the ESOP; the more income allocated to the ESOP, the less taxable income distributed to shareholders outside the ESOP. If the ESOP holds 100% of the shares of the S corporation, all profits are allocated to the ESOP, and federal and (usually) state income taxes are deferred until benefits are distributed from the ESOP, which a participant can defer to age 70½.

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This unique tax treatment offers an additional financial advantage to S corporations that sponsor ESOPs. Typically, an S corporation will make distributions to its shareholders to help them pay the federal and state income taxes on their portions of the S corporation's profits. Such distributions must be provided pro rata based on the number of shares held. If an S corporation that sponsors an ESOP makes distributions for shares held outside the ESOP, a pro rata distribution must be made for shares held in the ESOP as well. Since the ESOP doesn't need the money to pay taxes (remember, it's a tax-exempt trust), this influx of cash to the ESOP can be used to purchase additional shares. If the ESOP holds 100% of the shares, such a distribution isn't necessary, and no cash has to be paid out to shareholders to cover their taxes. Money not distributed to pay taxes can be reinvested in the S corporation.

The catch

We know Congress and the IRS would never offer the generous tax savings opportunity available through an S corporation ESOP without attaching some strings. For starters, not every for-profit organization can qualify as an S corporation.[2]

Privately held ESOP companies must obtain annual business appraisals to comply with ESOP requirements. An S corporation ESOP cannot use the relaxed deductions and maximum addition limits that are available to C corporation ESOPs. But the biggest catch is the so-called S corporation ESOP anti-abuse rule. This rule is intended to ensure that stock ownership of the S corporation is not limited to a few individuals or a few family groups. The anti-abuse rule is complex and failures result in egregious penalties that can potentially bankrupt a company.

Converting from C corporation to S corporation

It is relatively common for an eligible C corporation to convert to an S corporation as a way of eliminating double taxation. If you're the CEO or CFO of a C corporation, and you think that converting to an S corporation and establishing an ESOP is the perfect solution to all your tax woes, there are a few things that you need to consider. First, a C corporation that converts to an S corporation may run into some unfavorable tax issues. Other considerations include the impact of conversion on employee compensation and benefits—especially on employees who are 2% (or more) owners.

In perspective

For S corporations, the tax benefits of an ESOP go one step further than those associated with the typical qualified plan. Since the ESOP is a tax-exempt trust, the more shares held by the ESOP, the lower the tax bill. If you're already operating as an S corporation, then an ESOP may be an ideal way to lower taxes paid by shareholders and provide a qualified retirement plan to all employees.

While establishing and maintaining an ESOP isn't easy or cheap, as it requires the expertise of legal, tax, and ESOP professionals, many S corporations find the tax benefits available through the ESOPs well worth the effort and cost. If you're a C corporation considering conversion to an S corporation as a way to reduce taxes and add a valuable employee benefit, consider all aspects before making the leap. For C corporations considering conversion, there may be tax liabilities derived from the prior C corporation's operations; however, there could be significant tax benefits to C corporation shareholders who sell stock to an ESOP prior to the conversion to an S corporation.

[1] A Look at the Good, the Bad, and the Ugly of Employee Stock Ownership Plans," 2017.

[2] S corporations can have no more than 100 individual shareholders; shareholders must be U.S. citizens or resident aliens; only one class of stock is permitted, although, the stock can have voting and nonvoting shares; and the business must run on a calendar year basis.

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